

EXTENDING THE TIME FOR COMMITMENT OF VESSEL
CONSTRUCTION RESERVE FUNDS

JULY 6, 1959.—Ordered to be printed

Mr. MAGNUSON, from the Committee on Interstate and Foreign Commerce, submitted the following

R E P O R T

[To accompany S. 2013]

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (S. 2013) to amend section 511(h) of the Merchant Marine Act, 1936, as amended, in order to extend the time for commitment of construction reserve funds, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF THE BILL

S. 2013 would amend section 511(h) of the Merchant Marine Act of 1936, as amended, in order to afford shipowners additional time for commitment of construction reserve funds. Under section 511 of the act operators of vessels in domestic or foreign trade or in fisheries are permitted to set up a construction reserve fund, in which may be deposited earnings from vessel operations (and earnings from previously deposited construction reserve funds); proceeds from the sale of vessels and indemnities upon the loss of vessels. In respect to vessels sold or lost, no gain is recognized in the computation of net income if an amount equal to the net proceeds or net indemnity is deposited in the construction reserve fund. However, the tax basis of a new vessel purchased with such untaxed gain is reduced by the amount of the untaxed gain so used.

The vessel owner must, within 2 years, commit for construction, or expend for the purchase of new vessels, the amounts deposited in the construction reserve fund. However, the date for obligating the funds may be extended for an additional 2-year period under regulations prescribed jointly by the Maritime Administration and the Secretary of the Treasury.

The proposed extension of time sought in S. 2013 is intended to apply particularly to \$1,600,000 of reserve funds of American-

Hawaiian Steamship Co. which would be required to be committed under present law by July 9, 1959. The balance of their deposits, some \$9,400,000, must be committed between February and November in 1961. Even though, prior to passage of this bill, the date of commitment will have elapsed, the Secretary of Commerce would be authorized to grant a further extension, which would be effective as though the period of commitment had not elapsed.

Specifically, the bill would provide that until January 1, 1961, in addition to the extensions hereinbefore permitted, further extensions may be granted ending not later than December 31, 1961. It is further provided that the act shall take effect June 30, 1959, or on the date of enactment of the act, whichever date first occurs.

REASON FOR THE BILL

The American-Hawaiian Steamship Co. has been, since 1900, an important factor in the Nation's coastal, intercoastal and Hawaiian trades. At the outset of World War I it operated about 25 percent of the total freighter tonnage under U.S. registry. These vessels were of great value to the war effort, as were the 32 large freighters made available to the Government by American-Hawaiian in World War II. Twenty-two of these vessels were lost in the war, or requisitioned for title by the Government, and the indemnities received for the vessels were inadequate for a vessel replacement program at the high postwar construction costs.

After World War II, it was testified at the public hearings, the company made several efforts to resume service, first, as agents for the Government, then with chartered vessels, later with vessels purchased from the Government. Finally, it embarked upon an ambitious program, intended to include 10 high-speed trailerships, but after expending almost \$1 million for designing, found the construction costs too high for the program to be economically sound. In April of this year, application was made with the Maritime Administration for Federal mortgage insurance to cover four trailerships, modifications of earlier designs, for operation in intercoastal trade. Enactment of S. 2013 is necessary, however, to provide time for finalizing the vessel design and procuring the additional financing that will be required.

PROS AND CONS OF THE LEGISLATION

Extension of the period for commitment of the construction reserve funds directly involved would not establish a precedent. As pointed out in the Comptroller General's report on the bill—

Authority to grant additional extensions during specified periods has been granted at various times in the past by similar amendments to section 511(h).

The report of the Secretary of the Treasury offers no objection to enactment of S. 2013, stating—

* * * the Department would normally object in principle to further extensions. It is, however, cognizant of the unusual circumstances surrounding the efforts of the American-Hawaiian Steamship Co. to acquire vessels appropriate for the intercoastal trade as explained by you in the Congress—

sional Record (p. 7692) for May 20, 1959, and as supplemented by information supplied to the Department by the Maritime Administration. It appears that the company is proceeding as expeditiously as practicable with completing arrangements for the acquisition of new vessels. In view of these circumstances the Department would interpose no objection to the enactment of S. 2013.

Justification for favorable action on the bill is advanced by the Department of Commerce in its report, as follows:

American-Hawaiian Steamship Co. * * * testified at the hearing that the tax on their approximately \$11 million of deposits in construction reserve funds will be approximately \$2,500,000 if the time to expend and obligate these funds elapses before such funds can be invested in vessels. This is 25 percent of a capital gain of \$10 million.

If this \$10 million is invested in ships without payment of the capital gains tax, the ships will lose their basis for depreciation to the extent of \$10 million and American-Hawaiian Steamship Co. (if it makes sufficient earnings with the vessels, and if tax rates remain the same) would therefore pay \$5,200,000 in additional ordinary income taxes over the life of the vessels in lieu of the capital gains tax of \$2,500,000.

The Department believes that the extension of time within which to expend or obligate the construction reserve funds involved, for the limited additional period provided in the bill, should encourage the construction of some new modern tonnage by unsubsidized companies, and therefore recommends enactment of the bill, S. 2013.

While the matter of tax revenue to the Government, which this bill would defer, has some immediate significance, the long-range return to the Government in all likelihood will be far greater if all the company's construction funds are permitted to be invested in the proposed trailerships.

Because all of the money in the company's reserve fund are from vessel sales or indemnities from losses of vessels, they are subject, if withdrawn, to the 25 percent capital gains tax. When the funds are invested in new vessels, however, the depreciation basis of the vessels immediately is reduced by the amount of the funds invested therein. To the extent that the use of such funds reduces the depreciation deduction normally allowed a taxpayer on his vessel any profit on his new ship becomes subject to a lesser depreciation expense and thereby becomes subject to the normal 52 percent corporation tax rather than the 25 percent capital gains tax.

In addition, over the normal 20 year lifespan of the new vessels, corporation taxes on earnings thereof, plus taxes on the incomes of company officials, employees and vessel crews would far outweigh, in all probability, the instant loss of revenue to the Government as a result of the tax deferral sought under the bill.

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The reports of the interested Government departments and of the Comptroller General follow:

THE SECRETARY OF COMMERCE,
Washington, July 2, 1959.

Hon. WARREN G. MAGNUSON,
*Chairman, Committee on Interstate and Foreign Commerce,
U.S. Senate, Washington, D.C.*

DEAR MR. CHAIRMAN: This letter is in reply to your request of May 21, 1959, for the views of this Department with respect to S. 2013, a bill to amend section 511(h) of the Merchant Marine Act, 1936, as amended, in order to extend the time for commitment of construction reserve funds.

Section 511 of the Merchant Marine Act, 1936, authorizes any citizen of the United States to deposit in a construction reserve fund, for the purpose of constructing, reconstructing, or reconditioning vessels, (1) the proceeds of sale of vessels, (2) indemnities for the loss of vessels, (3) earnings from the operation of American-flag vessels, and (4) earnings made on amounts deposited in the fund.

No tax consequences ensue from the deposit in the fund of earnings from the operation of American-flag vessels or of earnings made on amounts deposited in the fund except that they will not be considered unreasonable accumulations of earnings.

Section 511(c), however, provides that if the taxpayer deposits in the fund the net proceeds of sale or net indemnity for loss of a vessel, no gain shall be recognized to the taxpayer for Federal income tax purposes with respect to such sale or loss if the taxpayer so elects on his income tax return. Thus the gain on the transaction would not be required to be included in the taxpayer's taxable income.

Section 511(d) provides that any vessel constructed, reconstructed, or reconditioned with such deposits of proceeds of sale or indemnity shall lose its basis for depreciation to the extent such deposits consist of unrecognized gain. The income tax of 25 percent on the unrecognized gain is thus deferred and the taxpayer ultimately pays in lieu of this tax (assuming he has sufficient earnings) a tax of 52 percent on an amount of ordinary income equal to the unrecognized gain.

Section 511(g) provides that the tax deferment of the proceeds of sale or indemnity will be lost, and the capital gains tax thereon will become payable, unless the deposit is expended (or obligated for expenditure), for the construction, reconstruction or reconditioning of vessels within 3 years of the date of such deposit. Section 511(h) provides that the Secretary of Commerce may extend this period for 2 additional years.

The act of December 23, 1944 (58 Stat. 90), added a proviso to section 511(h) to provide that, in addition to the foregoing extension, additional extensions could be granted which would end not later than 6 months after termination of the war. Public Law 586, 82d Congress (66 Stat. 760), amended this proviso to provide that further extensions could be granted that would end not later than September 30, 1953, and this is the presently existing provision of the proviso. All extensions which were granted under this proviso, of course, expired in 1953.

The bill would amend the foregoing proviso to provide that further extensions of time in which to expend or obligate deposits may be

granted but such extensions shall end not later than December 31, 1961.

As of June 1, 1959, there was \$14,514,823.93 on deposit in construction reserve funds belonging to eight corporations. Two of these construction reserve funds, in the amount of \$1.80 and \$7,495.92, contain no tax deferred funds. The other six construction reserve funds contain deposits which were made on various dates between July 9, 1954, and March 30, 1959, and the time within which to expend or obligate these deposits (after extensions authorized under existing law have been granted) will expire on various dates between July 9, 1959, and March 30, 1964.

The American-Hawaiian Steamship Co. is the only company that appeared at the subcommittee hearing. The bill would authorize an extension of time in which to expend or obligate seven deposits (aggregating \$11,645,401.96) which that company has made in its construction reserve funds, such authorized extension to be for approximately the following periods, respectively: 2 months; 3 months; 6 months; 8 months; 9 months; 10 months; and 30 months.

In addition the bill would authorize an extension of time to expend or obligate three deposits (aggregating \$1,154,500) made by two other corporations, such authorized extension to be for approximately the following periods: 3 months; 17 months; and 20 months.

American-Hawaiian Steamship Co. has on file with the Maritime Administration an application for title XI mortgage insurance to aid in the construction of four "lift-on lift-off" ships which will cost in the aggregate in excess of \$100 million. That company testified at the hearing that the tax on their approximately \$11 million of deposits in construction reserve funds will be approximately \$2,500,000 if the time to expend and obligate these funds elapses before such funds can be invested in vessels. This is 25 percent of a capital gain of \$10 million.

If this \$10 million is invested in ships without payment of the capital gains tax, the ships will lose their basis for depreciation to the extent of \$10 million, and American-Hawaiian Steamship Co. (if it makes sufficient earnings with the vessels, and if tax rates remain the same) would therefore pay \$5,200,000 in additional ordinary income taxes over the life of the vessels in lieu of the capital gains tax of \$2,500,000.

The Department believes that the extension of time within which to expend or obligate the construction reserve funds involved, for the limited additional period provided in the bill, should encourage the construction of some new modern tonnage by unsubsidized companies, and therefore recommends enactment of the bill, S. 2013.

The Bureau of the Budget has advised that there would be no objection to the submission of this letter to your committee.

Sincerely yours,

FREDERICK H. MUELLER,
Acting Secretary of Commerce.

OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, June 29, 1959.

Hon. WARREN G. MAGNUSON,
*Chairman, Committee on Interstate and Foreign Commerce,
New Senate Office Building, Washington, D.C.*

MY DEAR MR. CHAIRMAN: This is in response to your request for the Department's views on S. 2013, to amend section 511(h) of the Merchant Marine Act, 1936, as amended, in order to extend the time for commitment of construction reserve funds.

Section 511 of the Merchant Marine Act, 1936, as amended, permits any citizen operating a vessel in domestic or foreign commerce or in the fisheries to create a construction reserve fund and deposit therein (1) proceeds from the sale of vessels; (2) indemnities upon the loss of a vessel; (3) any earnings derived from shipping operations; and (4) earnings upon payments previously deposited in the fund. No gain is recognized for tax purposes upon the sale or loss of a vessel if the net proceeds or net indemnity is deposited in the construction reserve fund and if the taxpayer elects to treat such gains as not recognized. The amount of the untaxed gain then serves to reduce the basis of a new vessel subsequently purchased with such gain. Moreover, amounts deposited in the construction reserve fund are exempt from the application of section 531-537 of the Internal Revenue Code pertaining to the improper accumulation of surplus by corporations.

Amounts deposited in the construction reserve fund must be committed or expended for the acquisition of new vessels within 2 years from the date of the deposit except that the date for obligating these funds may be extended for an additional 2-year period under regulations prescribed jointly by the Maritime Commission and the Secretary of the Treasury. Present section 511(h) permits until March 31, 1953, further extensions to be granted ending not later than September 30, 1953. The bill S. 2013 would permit until January 1, 1961, still further extensions to be granted ending not later than December 31, 1961.

As of June 1, 1959, the balances in section 511 construction reserve funds aggregated approximately \$14,500,000. Approximately \$11.6 million or 80 percent of the aggregate represents deposits made by the American-Hawaiian Steamship Cos. of New York and Delaware, consisting principally of the proceeds of the sale of vessels. The time limitations on parts of these funds prescribed by section 511 expire at various times between July and November 1959, whereas arrangements for mortgage insurance and financing of the acquisition of the vessels for which the funds are being held will reportedly not be completed until sometime in 1960. The purpose of S. 2013 is to extend the time limitation on deposits in the construction reserve fund to accommodate this financing schedule.

The purpose of the time limitation within which these deposits must be obligated is to insure that the gains and income on which taxes are deferred are in fact used for fleet modernization. In prescribing the schedule contained in section 511 Congress can be assumed to have been guided by evidence that it would afford ship operators adequate time to complete arrangements for the acquisition of new vessels. Presumably also, operators who availed themselves of these provisions were familiar with the statutory requirements. Under these circumstances the Department would normally object in prin-

ciple to further extensions. It is, however, cognizant of the unusual circumstances surrounding the efforts of the American-Hawaiian Steamship Co. to acquire vessels appropriate for the intercoastal trade as explained by you in the Congressional Record (p. 7692) for May 20, 1959, and as supplemented by information supplied to the Department by the Maritime Administration. It appears that the company is proceeding as expeditiously as practicable with completing arrangements for the acquisition of new vessels. In view of these circumstances the Department would interpose no objection to the enactment of S. 2013.

The Bureau of the Budget has advised the Treasury Department that there is no objection to the submission of this report.

Sincerely yours,

DAVID A. LINDSAY,
Assistant to the Secretary.

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, June 22, 1959.

HON. WARREN G. MAGNUSON,
Chairman, Committee on Interstate and Foreign Commerce,
U.S. Senate.

DEAR MR. CHAIRMAN: Your letter dated May 21, 1959, acknowledged May 22, requests our comments on S. 2013, 86th Congress, a bill to amend section 511(h) of the Merchant Marine Act, 1936, as amended, in order to extend the time for commitment of construction reserve funds.

Section 511 of the Merchant Marine Act, 1936, is intended to provide an incentive for the construction, improvement, or acquisition of American vessels for operation in foreign or domestic commerce of the United States without operating-differential subsidy aid by allowing the operators certain Federal tax benefits based upon the amount and nature of deposits made in a construction reserve fund and their subsequent use for the purposes and within the time limits specified in the act. Under subsection (h) thereof, the Maritime Administrator is authorized to grant extensions of time for the use of such deposits, "* * * but such extension shall not be for an aggregate additional period in excess of 2 years with respect to the expenditures or obligations of such deposits or more than 1 year with respect to the progress of such construction * * *."

S. 2013 would provide that until January 1, 1961, further extensions may be granted for a period beginning upon its enactment or on June 30, 1959, whichever is earlier, and ending December 31, 1961.

Authority to grant additional extensions during specified periods has been granted at various times in the past by similar amendments to section 511(h). However, we have no information concerning the need for the amendment which is now proposed and, since the desirability of such amendment would appear to involve questions of policy for determination by the Congress, we make no recommendation concerning enactment of S. 2013.

Sincerely yours,

JOSEPH CAMPBELL,
Comptroller General of the United States.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in *italic*, and existing law in which no change is proposed is shown in roman):

MERCHANT MARINE ACT, 1936

(49 Stat. 1985, approved June 29, 1936)

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TITLE V—CONSTRUCTION—DIFFERENTIAL SUBSIDY

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SEC. 511(a) * * *

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SEC. 511(h) The Commission is authorized under rules and regulations to be prescribed jointly by the Secretary of the Treasury and the Commission to grant extensions of the period within which the deposits shall be expended or obligated or within which construction shall have progressed to the extent of 5 per centum of completion as provided herein, but such extension shall not be for an aggregate additional period in excess of two years with respect to the expenditure or obligation of such deposits or more than one year with respect to the progress of such construction: *Provided*, That until [March 31, 1953,] *January 1, 1961*, in addition to the extensions hereinbefore permitted, further extensions may be granted ending not later than [September 30, 1953] *December 31, 1961*.

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